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Report to the Chairman, Committee on  
Governmental Affairs, U.S. Senate

May 1992

## CONTRACT PRICING

Estimating Deficiencies  
Resolved Slowly, but  
Recent DOD Actions  
Should Help

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National Security and  
International Affairs Division

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May 28, 1992

The Honorable John Glenn  
Chairman, Committee on Governmental Affairs  
United States Senate

Dear Mr. Chairman:

This report is one in a series being issued in response to your request that we evaluate the adequacy of controls and oversight of Department of Defense (DOD) subcontracting. In this report, our objective was to determine whether DOD administrative contracting officers had taken sufficient actions to resolve subcontract estimating deficiencies in a timely manner.

## Background



Contractor estimating systems that produce reliable price proposals are a key safeguard to obtaining fair and reasonable contract prices. When a contract price is increased because it is not based on accurate, complete, and current data, the government has a right to a price reduction under the provisions of the Truth in Negotiations Act (P.L. 87-653, now codified at 10 U.S.C. 2306a). When contracts are overpriced because of poor estimating, the government may not recover the overstated prices under the act.

Government contracting officers are responsible for determining the adequacy of contractors' estimating systems. When the Defense Contract Audit Agency (DCAA) reports an estimating deficiency, DOD regulations establish procedures and time frames for their correction. If a contractor does not make adequate progress in correcting the deficiency, contracting officers are authorized to take actions to obtain correction, such as reducing or suspending progress payments, recommending nonaward of potential contracts, or disapproving all or part of the estimating system.

## Results in Brief

Our review at 11 defense contractors identified 61 subcontract (including material)<sup>1</sup> estimating deficiencies that had been reported by DCAA. Of the 11 contractors, we determined that 6 had taken substantive actions to correct almost all (32 of 33) of the deficiencies. The other 5 contractors

<sup>1</sup>Subcontract refers to all purchases from any supplier, distributor, vendor, or firm furnishing materials, supplies, or services to DOD prime contractors or subcontractors.

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had only effectively dealt with about one-third (10 of 28) of the deficiencies. Over half (33 of 61) of the deficiencies were not corrected in a timely manner.

The delays in correcting estimating deficiencies were due, in part, to the lack of aggressive actions by government contracting officers and their failure to follow established resolution procedures. Some contracting officers prematurely reported that the deficiencies had been corrected primarily on the basis of promised contractor actions.<sup>2</sup> The promised actions were either not implemented or proved inadequate. Delays also resulted when contracting officers asked DCAA to assist in evaluating contractors' corrective action plans, but DCAA did not respond until it conducted its normal follow-up review.

Ten estimating deficiencies involved the failure of contractors to analyze subcontract prices and provide the results to the government with their contract price proposals—a DOD requirement for the past 20 years. Also, 9 of the 11 contractors failed to reduce proposed material prices to reflect historical results of vendor negotiations—a requirement of an adequate estimating system. Our prior reports have shown that these deficiencies cause contract prices to be overstated by millions of dollars.

Over the last year, DOD took several steps to help reduce the time required to correct estimating deficiencies and strengthen its oversight. These actions included directing local managers to become personally involved in the resolution process, establishing or revising monitoring systems to track deficiencies until they are corrected, and revising selected procedures that contributed to the delays we identified. These actions, if adequately implemented, should help correct the problems we identified. However, we do plan to monitor DOD's implementation of these actions.

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<sup>2</sup>DOD Directive 7640.2 requires the DOD Inspector General to monitor the timely disposition of audit reports. Contracting officers should not report that disposition has occurred until, among other things, the contractor implements the recommendation. The Office of the DOD Inspector General, considers the term "implement" to mean that the action required to correct the deficiency has been completed.

## Corrective Actions Taken on Most Deficiencies, but Contractor Actions Vary

Substantive actions<sup>3</sup> had been taken to correct about 70 percent (42 of 61)<sup>4</sup> of the estimating system deficiencies reported by DCAA at the 11 contractors we reviewed. A description of the estimating deficiencies is shown in appendix I.

While corrective action had been taken on most of the deficiencies, the actions tended to be concentrated at 6 of the 11 contractors. These 6 contractors had taken action to correct 32 of their 33 deficiencies, while the other 5 contractors had only taken action on 10 of their 28 deficiencies.

In some cases, corrective actions resulted from contractors' initiatives without prodding by contracting officers. For example, within about 30 days of a draft DCAA report, one contractor agreed to correct all nine cited deficiencies. Within 6 months, the contractor revised its estimating procedures to address each deficient condition.

In other cases, contracting officers took active roles in ensuring that estimating deficiencies were corrected. For example, after delays had been encountered, a contracting officer placed a company in the Contractor Improvement Program<sup>5</sup> for more intensive management oversight. The contracting officer also withdrew approval of the estimating system, advised procuring offices of the latest action, and recommended that the company submit cost or pricing data on all proposals over \$25,000—significantly lower than the current \$500,000 threshold requirement. Shortly thereafter, the contractor revised its pricing procedures to correct the estimating deficiencies. While contracting officers imposed regulatory sanctions at only 3 of the 11 contractors we reviewed, this case illustrates that such actions can achieve positive results.

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<sup>3</sup>"Substantive action" refers to deficiencies that have either been corrected (39 deficiencies) or have had corrective action plans submitted (3 deficiencies).

<sup>4</sup>This amount does not include five deficiencies reported by DCAA that did not require corrective action.

<sup>5</sup>The Contractor Improvement Program identifies contractors with performance problems warranting intensive government monitoring.

## More Timely Actions Could Have Been Taken on Estimating Deficiencies

Although about 70 percent of the deficiencies we found had been corrected, over half (33 of 61) had not been corrected in a timely manner. Nineteen of the 33 deficiencies remain uncorrected at the time we completed our review. As shown in table 1, the 33 deficiencies remained uncorrected from 9 months to over 8 years.

**Table 1: Time Deficiencies Remained Uncorrected**

Period <sup>a</sup> (years)	Number of deficiencies		
	Corrected	Not corrected	Total
Less than 1	1	0	1
1 to less than 2	7	4	11
2 to less than 4	3	2	5
4 to less than 8	3	11	14
8 or more	0	2	2
<b>Total</b>	<b>14</b>	<b>19</b>	<b>33</b>

<sup>a</sup>We measured the period from the dates the deficiencies had initially been reported to either (1) the dates they were corrected or (2) the date we completed our review, if not corrected.

The delays were due, in part, to an absence of aggressive and pro-active measures by contracting officers, including failure to follow regulatory guidance on the resolution of estimating system deficiencies. For example, corrective actions on 11 estimating deficiencies, at 4 contractors, were delayed, in part, because contracting officers had prematurely reported that the deficiencies had been corrected primarily on the basis of promised actions that were either not implemented or proved inadequate.

Subsequent DCAA estimating system reviews repeatedly identified that the same deficiencies continued to exist. At the time of our review, 9 of the 11 deficiencies remained uncorrected for 4 years to over 8 years since they had initially been reported. We also found<sup>6</sup> that contracting officers had prematurely reported that estimating deficiencies at five contractors had been corrected during our evaluation of DOD's audit follow-up system.

At two other contractors, corrective actions on six estimating deficiencies were delayed, in part, because contractors' responses, including their corrective action plans, had not been promptly evaluated. We found that the contracting officers had requested that DCAA review the contractors' responses, but DCAA did not comply until it had conducted follow-up reviews—causing delays of 5 months and 8 months, respectively.

<sup>6</sup>Contract Pricing: DOD's Audit Follow-Up System Is Inaccurate and Incomplete (GAO/NSIAD-92-138).

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## Uncorrected Estimating System Deficiencies Can Increase Contract Prices

Uncorrected estimating deficiencies can result in millions of dollars in overpriced contracts. For example, at the 11 contractors, DCAA reported 10 cases where contractors had not performed required subcontract price analyses and had not provided the results to the government with the contract price proposal—a DOD requirement for the past 20 years. In April 1991, we reported<sup>7</sup> that another contractor with the same deficiency had evaluated subcontract proposals after prime contract price agreement and had used the results to negotiate subcontract prices that were about \$3.1 million less than the amount negotiated in the prime contract. We also reported<sup>8</sup> that the same deficiency at five of six contractors had resulted in negotiated subcontract prices that were \$10.1 million or 11 percent less than amounts negotiated in the prime contracts.

Nine of the 11 contractors we reviewed had also been cited for failing to reduce proposed material prices to reflect historical results of vendor negotiations—a basic requirement of an adequate estimating system. In February 1989, we reported<sup>9</sup> the same problem at four contractors had resulted in material purchases that were \$2.5 million less than the amounts negotiated in the prime contracts. In another example, we reported that six contractors had purchased material for \$1.7 million less than the amounts negotiated in the prime contracts.

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## Recent DOD Management Initiatives to Correct Estimating System Deficiencies

Over the last year, DOD took actions to better ensure that estimating deficiencies were corrected in a timely manner. The Defense Logistics Agency issued five guidance letters instructing its district and field office commanders to (1) become personally involved in resolving estimating deficiencies, (2) ensure that regulatory sanctions are applied when contractors do not make satisfactory progress in correcting estimating deficiencies, and (3) use effectively the Contractor Improvement Program to provide more intensive management oversight of problem contractors.

DOD also took steps to improve its oversight of the resolution process. In December 1991, the DOD Inspector General reported that it would track contractors progress in correcting estimating deficiencies, report the

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<sup>7</sup>Contract Pricing: Inadequate Subcontract Evaluations Often Lead to Higher Government Costs (GAO/NSIAD-91-161, Apr. 5, 1991).

<sup>8</sup>Contract Pricing: Defense Contractor Cost Estimating Systems (GAO/NSIAD-87-140, June 3, 1987).

<sup>9</sup>Contract Pricing: Contractors Should Provide Historical Vendor Prices to DOD (GAO/NSIAD-89-68, Feb. 15, 1989).

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results to DOD components, and increase oversight of DCAA audit reports that recommended disapproval of contractor estimating systems. In addition, the Defense Logistics Agency established a quarterly reporting system to track the status of contractor estimating system deficiencies.

DCAA also issued three guidance letters to its field offices to resolve specific problems that had contributed to delays in correcting estimating deficiencies. On December 12, 1991, DCAA instructed its auditors to promptly evaluate contractor corrective action plans when requested by the contracting officer instead of waiting until its scheduled follow-up review. Other DCAA guidance instructed DCAA auditors to (1) identify the cost impact of each estimating deficiency reported and (2) recommend that contracting officers disapprove all or a portion of the contractor's estimating system and lower the dollar threshold for obtaining cost or pricing data when a significant estimating deficiency is reported.

Finally, on March 30, 1992, the Defense Logistics Agency directed its contracting officers to continue to report the status of estimating system reports until all deficiencies have been corrected or other action has been taken. According to the guidance, until the corrective action is implemented and verified, contracting officers should designate a monitor to track the contractor's progress and advise the contracting officer, in writing, of the progress made.

These actions, if adequately implemented, should reduce the time required to correct estimating deficiencies and strengthen DOD's oversight of the resolution process. Accordingly, we are not making additional recommendations at this time. However, we do plan to monitor DOD's implementation of these actions.

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## Scope and Methodology

We selected recent DCAA estimating system reports covering 11 defense contractors in 3 DCAA regions. We reviewed correspondence files at contractor and DOD contract administration and contract audit offices to establish the existence and timeliness of various actions to correct estimating system deficiencies identified in the DCAA estimating system reports. In addition, we reviewed contractors' pricing and estimating procedures and their corrective action plans. Also, we evaluated contracting officer and DCAA activities, including actions to evaluate the adequacy and implementation of contractor corrective action plans, use sanctions to encourage correction of estimating deficiencies, and conduct contract audit follow-up as well as price proposal audits. Finally, we

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reviewed relevant DOD acquisition regulations as well as contract administration and contract audit policy guidance, audit monitoring activities under DOD Directive 7640.2 procedures, and agency oversight of contracting officers actions to correct estimating system deficiencies.

We classified DOD's efforts to correct reported estimating deficiencies as untimely when our case-by-case assessment identified unnecessary delays in evaluating corrective action plans and monitoring progress toward correcting the deficiencies. In general, these deficiencies would be classified as overage under the provisions of DOD Directive 7640.2, Policy for Followup on Contract Audit Reports because they remained uncorrected for a year or more.

Our review was conducted between July 1991 and January 1992 in accordance with generally accepted government auditing standards. As agreed with your office, we did not obtain written agency comments on the report. We did, however, discuss the results of our review with contractor as well as DOD contract administration and contract audit representatives.

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Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Secretary of Defense; the Directors of the Defense Logistics Agency and DCAA; Director, Office of Management and Budget; and other interested congressional committees. Copies of this report will also be made available to others upon request.

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix II.

Sincerely yours,



Paul F. Math  
Director, Research, Development, Acquisition,  
and Procurement Issues

# Subcontract and Material Estimating Deficiencies

Description of estimating deficiencies	Number of deficiencies
Failure to perform timely or adequate analysis of subcontract price proposals	10
Failure to use appropriate material decrement factors	9
Failure to consider residual inventories in material pricing	7
Failure to submit consolidated priced bills of material	6
Failure to obtain or submit Standard Form 1411 Price Proposals for subcontract and intercompany work	5
Failure to adequately support proposed material scrap and attrition factors	5
Use of stand-alone pricing instead of economic order quantity pricing	3
Use of unsupported material escalation factors	2
Other estimating deficiencies	14
<b>Total</b>	<b>61</b>

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